No shocks expected from US

The week

William McInnes

Australian shares are set to open the week slightly lower ahead of the 2018 US midterm elections on Tuesday, with analysts saying the Democrats' expected victory in the House of Representatives has largely been priced into local markets.

On Sunday, ASX futures were down 5 points or just under 0.1 per cent, indicating the local market would open the week lower after US stocks closed Friday's trading in the red.

Concerns a trade deal with China was further away than first thought saw the S&P 500 close 0.6 per cent lower, despite the index opening the session higher on the back of positive non-farm payroll data. The S&P 500 ended last week up 1 per cent, but Australian shares held up much better, ending last week 3.2 per cent higher.

President Donald Trump blows a kiss at a campaign rally for Senator Ted Cruz in Houston, Texas. PHOTO: AP

While trade concerns will be front of mind for Australian investors at the start of the week, attention will quickly turn to the US midterms, with the result of the elections set to be released during local trading on Wednesday.

All 435 seats in the US House of Representatives and 35 of the 100 seats in the Senate will be contested on Tuesday US time, with the most likely result being the Republicans retain control of the Senate and Democrats take control of the House.

While Australia will be one of the first markets to react to the result, analysts said it's unlikely to move markets to a great degree with the most probable result already priced in.

"The US midterms will have some impact on the markets, but I believe the base case which is expected will not move markets to a great degree," said THB Asset Management chief executive Christopher Cuesta. "Right now Republicans control the executive branch, the House and Senate. Most polls suggest the Democrats will regain control of the House, but not the Senate.

"Under that scenario there will be a divided Congress that would leave the direction of existing policy unchanged, with no major changes to tax, spending or trade policies. There will be minimal impact to the economy or growth rates so there should be no impact on the stocks. A remote possibility under this scenario could be bipartisan support for an infrastructure bill, which would be viewed favourably by the market."

Mr Cuesta said his next most likely outcome, that Republicans maintain control of both houses, would be the most favourable for equities. "Scenario two would see the Republicans maintain their existing control and would likely cause an expansion of the tax cuts and fiscal stimulus policies already in place," he said. "This is the most 'risk on' outcome and likely to cause a sharp market move as it appears the market is pricing in the first scenario."

Mr Cuesta said markets would react negatively were the Democrats to take control of both houses. "This would bring increased probability of rising regulation, renewed single-payer healthcare policies and possibly higher minimum wages," he said. "This would be negative for equities and the US dollar. Rates will likely fall too."

President Donald Trump has already touted what a Democrat victory would do to the markets, tweeting on Tuesday: "If you want your Stocks to go down, I strongly suggest voting Democrat."

Morphic Asset Management head of macro and risk Geoff Wood said a Democratic victory in both houses would likely result in Mr Trump ramping up trade tensions, something that could pose a risk to Australia.

"If the Democrats manage to win both, it doesn't leave Trump with much power," he said. "It only leaves him with the tariffs and he might end up driving the tariff debate with China even harder. He likes headlines and the only thing he can lever with is tariffs.

"It isn't always obvious how the market will react," he said. "It's one thing to have a game plan but you have to be able adjust."

Behind the decoupling of US, Aussie rates

Market minds

Chris Dickman

Australian and US markets have enjoyed such a close relationship, it has been easy to view Australia as the 51st state.

Of course, that's an oversimplification. But with that in mind, it's worth investigating why that no longer seems to be the case. Why are Australian yields so far below the US?

Is the US economy growing faster than Australia? Actually, no. The most recent real GDP reading has Australia's year-on-year growth at 3.4 per cent, versus 3 per cent for the US. Both nations have falling and historically low levels of unemployment. But there are a number of key differences.

That Australia's jobless rate has recently fallen to about 5 per cent is a remarkably good outcome, when you consider Australia's population has grown by about 16 per cent over the last decade. Although Australia has absorbed the uplift in the labour force, part of the answer lies in underemployment.

In the aftermath of the GFC, US underemployment, as measured by U6, peaked at around 17 per cent. At the same time, Australia's underemployment was about 7.8 per cent. US underemployment has fallen to 20-year lows. It is now 7.8 per cent, while Australia's has actually increased, to 8.2 per cent. In that time, the retirement of the Baby Boomers has been a phenomenon shared by both economies, naturally tightening the labour market. After adjusting for inflation, median household incomes show Australia largely at the same level as it was in 2014.

US median household incomes are nearly 10 per cent higher. This also reflects the pressures that explain why inflation momentum is on a slightly different path. Core US inflation has shifted more consistently above the Federal Reserve's 2 per cent target, while Australia's core inflation is below the bottom end of the Reserve Bank's 2 to 3 per cent target.

Budget conditions are also on a different path. Australia is on track to record a budget surplus. Private building construction is growing with the uplift in population, but also contributing to federal and state revenue. Tax receipts from businesses have been particularly strong, and low unemployment helps. Government-sponsored infrastructure projects are contributing to economic growth but given asset recycling, are sensibly funded. In the US, although unemployment is low, large tax cuts have grown the budget deficit 17 per cent this year, now about $US779 billion, or 3.9 per cent of GDP, and on its way to 5 per cent of GDP.

Not only is the US Treasury issuing more securities, the Fed, having been a price insensitive buyer, is now a seller. The pace at which it reduces its treasuries and mortgage security bond holdings is now $US150 billion per quarter.

Importantly, the Bank of Japan and European Central Bank asset purchase programs are continuing, although at a slower pace. The spillover effects of these continue, where investors are effectively forced to chase yield in alternative markets, but to do so in a diversified fashion.

The US budget deficit will require greater Treasury issuance to fund it. PHOTO: BLOOMBERG

Since September 2016, the monthly average of net purchases by long-term Japanese investors in foreign bonds is instructive, if used as an indicator of a broader investor base. Average monthly purchases of French bonds stands at ¥109 billion, followed by Australia's at ¥91 billion.

Japan was a small net seller of low yielding German bunds, but mostly was busy selling ¥419 billion worth of US treasuries. This reflects the need for diversification away from already large holdings, as well as their expensiveness on a currency-hedged basis, or the likelihood of currency related losses on an unhedged basis.

It was a long time ago, but we've been here before.

Between June 1997 and December 2000, with the tech boom building and the Asian crisis perceived to have hurt Australia, it was old economy (Australia) versus new economy (US). US cash rates were largely higher than Australian cash rates for all of this period. Only then have long-term Australian bonds traded below US long bond rates.

Even then, it was only on three very brief occasions. Moreover, the furthest Australian 10-year traded below the US 10-year was 16 basis points. For the most part, the margin saw Australia higher by 50 basis points.

Also over this time, the Australian dollar fell from about US78¢ to around US58¢. It has fallen in 2018 too. With a lower currency, imported inflation lifts, and demand for domestically produced goods and services benefit too.

There is a fear that US interest rates are set to explode higher, and take Australian interest rates with them. Even if US interest rates do move higher, Australia is less pressured to follow. European and Japanese investors search for higher yielding Australian bonds will remain.

Given the ECB is very slowly reducing their purchases of European bonds, their yields will slowly drift higher, but hardly what you would call taking flight. And middle-class incomes are not yet strong enough to demonstrate a broad-based lift in consumer activity, business investment or inflation pressures.

Chris Dickman is a senior portfolio manager at Altius Asset Management.

The week ahead

MONDAY

- **Eco:** October China Caixin PMI services; Bank of Japan policy meeting; US October ISM non-manufacturing index
- **Results:** Westpac FY18 earnings
- **Speech:** Xi Jinping keynote at Shanghai International Import Expo; Bank of Canada's Poloz speech in London

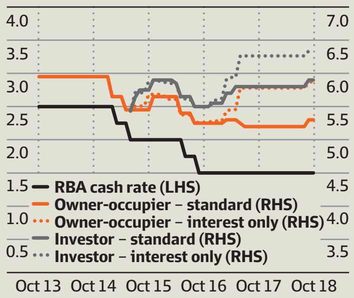
TUESDAY

- 2018 US mid-term elections
- **Eco:** RBA cash rate target

"Overall, the midterms are still unlikely to have a significant bearing on the economic outlook. But there is probably as much chance of policy becoming a headwind for growth as there is of another fiscal boost.

Andrew Hunter Capital Economics US economist

RBA cash rate and mortage interest rates (%)



WEDNESDAY

- **Eco:** NZ 3Q unemployment rate
- **Results:** CBA 1Q19 trading update
- **AGMs:** CBA, Domino's Pizza; News Corp

THURSDAY

- **Eco:** RBNZ official cash rate; China October trade balance; Bank of Japan summary of opinions; US FOMC rate decision
- **Results:** Eclipx Group FY18 earnings; James Harding 2Q19 earnings; News Corp 1Q19 earnings; Pendal Group FY18 results; REA Group 1Q19 earnings; Xero S119 earnings
- **AGMs:** BHP Billiton, Flight Centre Travel Group, Sims Metal Management, Trade Me Group

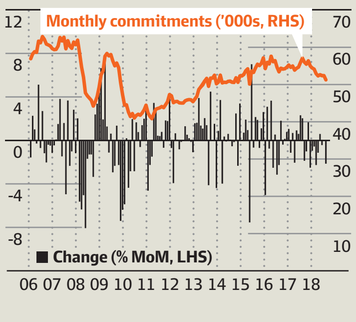
"Based on recent NZ data, Thursday's Monetary Policy Statement should have the RBNZ talking more about upside risks to the OCR than downside risks.

Craig Ebert BNZ senior economist

FRIDAY

- **Eco:** RBA statement on monetary policy, AU September home loans; China October PPI; UK September GDP; University of Michigan sentiment
- **Results:** Unibail-Rodamco-Westfield 3Q18 earnings
- **AGMs:** Nanosonics

Housing finance, Sep 2018



SOURCES: WESTPAC, ANZ